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In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 1333

MISSOURI PACIFIC RAILROAD COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The Court of Claims filed two opinions in this case. The first (Pet. App. 13–24) is reported at 427 F. 2d 727; the second (Pet. App. 25–28) is reported at 433 F. 2d 1324.

JURISDICTION

The original decision of the Court of Claims was filed on June 12, 1970 (Pet. App. 13). Both parties filed timely motions for reconsideration. On November 13, 1970, the court granted the government's motion and denied petitioner's motion, and entered its second opinion (Pet. App. 25). Petitioner's motion for rehearing of the second decision was denied on February 5, 1971. The petition for a writ of certiorari was

filed on February 9, 1971. The jurisdiction of this Court rests on 28 U.S.C. 1255(1).

QUESTION PRESENTED

Whether the court below correctly held that petitioner did not incur amortizable bond discount when, in a reorganization under Section 77 of the Federal Bankruptcy Act, it issued new bonds in exchange for old bonds of equivalent maturity value, and new bonds in exchange for stock which was of equivalent value in the view of the Interstate Commerce Commission and the federal courts reviewing the reorganization.

STATUTE AND REGULATIONS INVOLVED

The pertinent statutory and regulatory provisions are set forth in Appendix A to the petition (p. 12).

STATEMENT

Effective March 1, 1956, petitioner and its subsidiaries were reorganized and merged under Section 77 of the Federal Bankruptcy Act, 11 U.S.C. 205, pursuant to a plan of reorganization approved by the Interstate Commerce Commission and reviewing federal courts. In accordance with the plan, so far as pertinent, petitioner issued new interest-bearing debt securities (collateral trust notes, mortgage bonds and debentures, collectively hereinafter "new bonds") largely in exchange for its own old bonds and bonds of its subsidiaries. In many cases, new bonds were issued for old bonds of equal face value, with the interest accrued on the old bonds being paid in cash. In the remaining bonds-for-bonds exchanges, the new bonds were equal in face amount to the face amount

of the old bonds plus accrued interest thereon.[1] All unamortized discount on the old bonds was carried forward and amortized during the life of the new securities. (Pet. App. B 14–15, 21.)

Petitioner also exchanged its new bonds for publicly-held stock of a 94 percent owned subsidiary, the New Orleans, Texas and Mexico Railway Company (hereinafter "New Orleans") (Pet. App. B 20–21). In petitioner's reorganization proceedings, the Interstate Commerce Commission and the reviewing federal courts determined, after thorough consideration, that the New Orleans stock was worth $250 per share, and that $216 in maturity value of new bonds should be allocated to each share of stock as its "equitable equivalent" (Pet. App. B 27).

Petitioner asserted below (Pet. App. B 15–16), as here, that it incurred bond discount in the amount of the excess of the face value of the new bonds over the New York Stock Exchange price quotations for the old securities at the time of the exchange. The court below rejected this contention. Limiting its conclusions to exchanges within a corporate family, the court ruled first that the only relevant value to petitioner of the old bonds was their face amount and, hence, that the issuance of new bonds for equivalent indebtedness was an exchange of equal values in which no discount was incurred (Pet. App. B 18, 21). As for

[1] The court below has remanded to the trial commissioner the essentially mechanical question as to whether there was an equivalence of face values in the exchange of petitioner's new bonds for the old bonds of one subsidiary, the Little Rock & Hot Springs Western Railroad Company.

the exchange of new bonds for New Orleans stock, the court held on rehearing that no discount was incurred because there was an exchange of equivalent values as determined by the Interstate Commerce Commission and confirmed by the reviewing courts (Pet. App. B 27).[2]

ARGUMENT

The decision below is correct in result. There is no direct conflict or other warrant for further review.

1. Bond discount has been characterized as a form of deferred interest—an amount to be paid *in futuro* for the use or forbearance of money. *Helvering* v. *Union Pacific Co.*, 293 U.S. 282, 286; *United States* v. *Midland-Ross Corp.*, 381 U.S. 54, 66. The fact and amount of a discount is clear where bonds are issued for a cash amount which is less than the face amount of the bonds. Such a discount is amortizable by the issuer, so that the cost of the future interest may be deducted ratably over the life of the bonds. It seems clear that a similar result should follow where bonds are issued for property under a contract which places an agreed price on the property and thereby reflects a discount bargained for at arm's length.

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[2] The court held in its first opinion that petitioner would have incurred discount if the face amount of the new bonds exceeded the amount originally paid in for the New Orleans stock, and remanded the issue for further proceedings (Pet. App. B 22–24). On rehearing, the court withdrew the remand and modified its views to hold that there could be discount only to the extent that the face amount of the new bonds exceeded the greater of (1) the amount originally paid in for the stock or (2) the value of the stock at the time of the exchange, taking into account not only the current market quotations but other factors bearing on the value of the stock *to petitioner*.

The situation is entirely different where bonds are simply issued in exchange for property (including securities) without negotiation of an agreed purchase price which reflects a discount. In such circumstances it is the government's general position that discount may not be imputed by reference to fair market value or any other factor—that the parties have in substance contracted to make an even exchange, with the property acquired taking as its cost basis the face amount of the bonds issued. Any other result attributes to the parties a contract they did not make, imputing interest for which they did not provide. This is contrary to recognized tax principles (*Bethlehem Steel Corp.* v. *United States,* 434 F.2d 1357 (Ct. Cl.); *Commissioner* v. *Danielson,* 378 F. 2d 771 (C.A. 3), certiorari denied, 389 U.S. 858; *M. C. Parrish & Co.* v. *Commissioner,* 147 F. 2d 284 (C.A. 5); *Hundahl* v. *Commissioner,* 118 F. 2d 349 (C.A. 5)) and to decisions squarely involving exchanges of bonds for property (*Southern Natural Gas Co.* v. *United States,* 412 F. 2d 1222 (Ct. Cl.); *Montana Power Co.* v. *United States,* 159 F. Supp. 593 (Ct. Cl.); *Sacramento Medico Dental Building Co.* v. *Commissioner,* 47 B.T.A. 315). In the instant case no agreed price or discount was negotiated by the parties.

In rejecting petitioner's claim that it incurred bond discount upon issuance of the new bonds, the court below did not squarely pass upon the validity of the government's general position, as outlined above. Rather, it found that under no theory could a discount be established in the particular circumstances herein. This finding is clearly correct.

Petitioner issued the new bonds in exchange for equivalent face amounts of its old bonds and bonds of its wholly-owned subsidiaries which were merged into it. It contends that the exchanges should be treated as if it had bought the old bonds for cash and issued the new bonds in a separate transaction. But this Court rejected a similar contention under similar circumstances (except that subsidiaries were not involved) in *Gt. W. Power Co.* v. *Commissioner,* 297 U.S. 543. The Court there held (297 U.S. at 546) that there was a substitution of obligations which required the taxpayer to carry over unamortized discount on the old bonds and to amortize it (together with other expenses attributable to the issuance of the new bonds) over the life of the new securities. This ruling applies to the bonds of petitioner's subsidiaries, as well as to petitioner's own bonds, since petitioner absorbed its subsidiaries and assumed their liabilities as its own in the reorganization.

The rationale of the ruling is cogently stated by the court below (Pet. App. B 17–18). The court recognized that when a debtor issues new bonds in substitution for old bonds of equivalent maturity value, bond discount cannot be determined by reference to the market value of the old bonds which are to be cancelled. This value is meaningless to the debtor because the old bonds will no longer be subject to market conditions, and the debtor will be in the same position after the exchange as it was previously, the amount of its indebtedness not having been reduced. To recognize bond discount in these circumstances (in excess of the unamortized discount on the old bonds

which may be carried over) would permit a debtor to generate income tax deductions merely by reshuffling its financial structure, but without any real change in that structure. It would, as the court below concluded (Pet. App. B 18), "give credence to an illusional or fictional interest charge which does not actually exist. * * * [Petitioner] would be unjustly increasing the amount of its deductions without correspondingly increasing its obligations."

It is likewise clear in the special circumstances of this case that petitioner did not incur bond discount in issuing new bonds for the New Orleans stock. The fair market value of the New Orleans stock was extensively litigated over several years in the reorganization proceedings before the Interstate Commerce Commission (*Missouri Pac. R. Co. Reorganization,* 275 I.C.C. 59, 113, 125–127), and before the District Court for the Eastern District of Missouri (*In re Missouri Pac. R. Co.,* 93 F. Supp. 832, 848–849; 129 F. Supp. 392, 399). The issue was appealed on three different occasions by the New Orleans stockholders, who claimed that the stock had a value of $390 per share, and this Court twice denied applications for certiorari. *State of Texas* v. *Group of Institutional Investors,* 191 F. 2d 265, 273–274 (C.A. 8), certiorari denied, 343 U.S. 929; *Missouri Pacific Railroad Co. 5¼% S.S.B.C.* v. *Thompson,* 225 F. 2d 761, 765 (C.A. 8), certiorari denied, 350 U.S. 959; *Missouri Pacific Railroad Co., Etc.* v. *Thompson,* 229 F. 2d 898, 900 (C.A. 8).

The upshot was that the New Orleans stock was valued at $250 per share. Only $216 in maturity value

of bonds were allocated to each share on the ground that the bonds were "of higher grade" and therefore "the equitable equivalent" of the stock. *Missouri Pac. R. Co. Reorganization,* 290 I.C.C. 674, 678–679. It was eminently reasonable for the Court of Claims to adopt the determination of the expert administrative body and the bankruptcy and appellate courts to which Congress has delegated the functions of determining security values and insuring the fairness of a railroad insolvency reorganization. See *R.F.C.* v. *Denver & R.G.W.R. Co.*, 328 U.S. 495, 508; *Arkansas-Missouri Power Corp.* v. *Paschal,* 243 F. 2d 584, 588 (C.A. 8).

In sum, it was authoritatively determined that petitioner did not give up any greater value than it acquired in exchanging bonds for New Orleans stock, and this determination was reflected in the contract of the parties—the reorganization plan as finally approved.

2. Contrary to petitioner's assertion (Pet. 4), the decision here is not in "direct conflict" with *Nassau Lens Co.* v. *Commissioner,* 308 F. 2d 39 (C.A. 2), and *American Smelting & Refining Co.* v. *United States,* 130 F. 2d 883 (C.A. 3). There is not even an arguable conflict with *Nassau Lens.* In that case the taxpayer purchased inventory at an agreed price of $100,000, issuing therefor one hundred $1,000 debenture notes. Each note provided for yearly increases in the redemption price. These increases obviously represented the cost of borrowing rather than payment of the agreed purchase price, and the court properly held that the increases were amortizable discount. Con-

cededly, in *American Smelting & Refining Co.*, the court employed a different method of valuing stock for which new bonds were issued than the method employed by the Court of Claims here—but in a significantly different context. In *American Smelting*, the court valued the stock by reference to market quotations. It did not, however, have the authoritative administrative and judicial determination of value which the Court of Claims had here; if it had, there is no reason to believe that the Third Circuit would not have accepted such a determination.[3]

3. As petitioner notes (Pet. 6), there is some confusion among the courts concerning the circumstances under which bond discount may be incurred in exchanges of bonds for property. The matter continues to be of administrative importance notwithstanding the provisions added to the Internal Revenue Code by the Tax Reform Act of 1969 as to bonds issued after May 27, 1969 (Section 1232(b) of the Code, as amended by Section 413(b) of P.L. 91–172, 83 Stat. 611). This is not an appropriate case for certiorari, however, because it is clear that petitioner did not issue new bonds with a value greater than the value to it of the old securities. Hence, under any theory, no bond discount was incurred here.

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[3] *Amicus* incorrectly alleges conflict between the decision below and the decision of the same court in *Union Pacific Railroad Co.* v. *United States*, 401 F. 2d 778, certiorari denied, 395 U.S. 944. There is no conflict. In both cases, the Court of Claims refused to impute discount in an exchange of bonds for stock, rejecting the contention that market quotations at the time of exchange required recognition of discount. Moreover, any inconsistency in the decisions of the Court of Claims would afford no basis for review by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.
JOHNNIE M. WALTERS,
Assistant Attorney General.
PHILIP R. MILLER,
GRANT W. WIPRUD,
Attorneys.

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